

State of California
BOARD OF EQUALIZATION
SALES AND USE TAX REGULATIONS

Regulation 1501.1. RESEARCH AND DEVELOPMENT CONTRACTS.

Reference: Sections 6006, 6009, 6010, 6011, and 6012, Revenue and Taxation Code.

(a) DEFINITIONS.

- (1) **QUALIFIED RESEARCH AND DEVELOPMENT CONTRACT.** A qualified research and development contract is a contract for a service where:
- a. the service provided under the contract is undertaken for the purpose of discovering information which is technological in nature, the results of which are intended to be useful in the development of a new or improved product, process, technique, or invention, and
 - b. the contract calls for the delivery of a report detailing information developed by the contractor or other tangible personal property incidental to the true object of the contract, as defined in Regulation 1501 (18 CCR 1501).
- A qualified research and development contract shall not include a contract for research for the purpose of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors. A qualified research and development contract shall also not include a contract for the design and production of a custom-made item as defined in subdivision (a)(5).
- (2) **RESEARCH.** A planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (product) or a new process or technique (process) or in bringing about a significant improvement to an existing product or process.
- (3) **DEVELOPMENT.** The translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use.
- “Development” includes the conceptual formulation, design, and testing of product alternatives, and construction of prototypes but does not include:
- a. routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements, and
 - b. market research or market testing activities.
- (4) **TANGIBLE PERSONAL PROPERTY.** Tangible personal property transferred in a qualified research and development contract includes, but is not limited to the following:
- a. Appearance model — a non-operating model of a design that is a physical representation of the design which is used to convey the image, texture and appearance of the design.
 - b. Prototype model — an operating model of a design the purpose of which includes:
 1. validating design concepts,
 2. validating design specifications,
 3. demonstrating design integrity, or
 4. demonstrating manufacturability of the design.
 - c. Prototype or temporary tooling — tooling produced and used in the development of prototypes.
- (5) **CUSTOM-MADE ITEMS.** A custom-made item includes, but is not limited to the following:
- a. Property the purchaser wants for its intrinsic values as an item, and for which the purchaser is not interested in the data developed in the course of the manufacture of the custom-made item.
 - b. Property the purchaser will use for purposes other than informational and testing purposes as defined in subdivision (a)(7).

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- c. Property purchased for use by the purchaser or for resale.
 - d. Production tooling — tooling produced and used for the manufacture of final production units.
- (6) **FUNCTIONAL USE.** Use for which the property was designed which occurs after completion of the research and development. Custom-made items normally are intended for functional use and not for informational and testing use. Informational and testing use of a prototype by the contractor or its customer does not qualify as a functional use.

Examples of functional use include:

- 1. Use as test fixtures in manufacturing equipment.
 - 2. Use as production tooling.
- (7) **INFORMATIONAL AND TESTING USE.** Use by either the contractor or its customers including, but not limited to:
- 1. Testing for verification of a design to specifications.
 - 2. Developing data, algorithms, ideas and/or knowledge to improve or perfect a design.
 - 3. Determining alternative design features and implementations.
 - 4. Validating testing of software and firmware embodied within a design.
 - 5. Demonstrating operation of a design for approval by a customer.
 - 6. Quality assurance and performance testing to determine limitations and failure modes of the design.
 - 7. Determining or improving interfaces to other equipment during the design process.
 - 8. Determining or improving the processes for manufacture of the design.
 - 9. Testing to design failure.
 - 10. Evaluating numerous prototypes for the acceptability of the design and the manufacturability of such design. Qualifying evaluation does not include any functional use of the property in a normal business operations capacity.
 - 11. Testing prototypes to assure that the design works to the specifications desired.
- (8) **PHASED CONTRACTS.** A phased contract is a contract which provides for separate phases wherein the purchaser has the specific right to terminate the contract prior to commencement of the next phase without the delivery of tangible personal property required to be delivered in any subsequent phase specified in the contract and without further obligation except for compensation for work completed or cancellation fees.

A contract for the design and manufacture of a custom-made item shall be considered a “phased contract” when:

- 1. the purchaser has the specific right to terminate the contract prior to or upon completion of the design phase, or
- 2. there are two separate contracts: one for the design service and the other for the manufacture of the custom-made item.

(b) APPLICATION OF TAX.

- (1) **GENERAL.** Persons engaged in the business of rendering services pursuant to a qualified research and development contract are consumers of tangible personal property which they use incidentally in rendering the service. Tax applies to the sale of the property to them. Tax does not apply to receipts derived from qualified research and development contracts except as provided below.
- (2) **PROTOTYPES.** Prototypes transferred in a qualified research and development contract for informational and testing purposes, as defined in subdivision (a)(7), are not subject to tax regardless of the fact the research contract may place a value on the prototype. Prototypes transferred are for verification that a design meets the required technical specifications of the contract. No functional use, as defined in subdivision (a)(6), of the prototypes is made. Either the sales tax or the use tax applies with respect to sales of such tangible personal property to the contractor.

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Sales of additional prototypes transferred in a qualified research and development contract for purposes other than informational and testing use, where a functional use occurs, are subject to tax. This includes prototypes transferred for the purpose of testing the aesthetic features of the product by independent third parties for marketing purposes, or used for the purpose for which the property was designed. The measure of tax is the stated value for such property in the contract, or if none is stated, at the computed fair market value as determined by applying a factor of three to the cost of direct materials used in the production of the prototype.

Tax applies to the transfer of title or possession of prototype tooling, in a qualified research and development contract, for functional use as defined in subdivision (a)(6), regardless of the form of the media, even if a separate charge is not made for these properties. The measure of tax is the amount provided for in the contract for duplicate or replacement sets of the property, or if no such amount is provided, the measure of tax will be equal to fair market value as determined by applying a factor of three to the cost of direct materials used in the production of the prototype tooling.

- (3) **CUSTOM-MADE ITEMS.** A contract to design, develop, and manufacture a custom-made item is a contract to sell tangible personal property. Generally, custom-made items are intended for functional use and not for informational and testing use. Unless the sale of the property is a sale for resale, tax applies to the gross receipts from the sale of the property. Gross receipts includes the entire amount of the contract price, including charges related to research, design, and development activities. Tax applies to the entire contract price without regard to the fact that the research, design, and development charges may be separately stated. See subdivision (b)(4) if the contract qualifies as a phased contract.
- (4) **PHASED CONTRACTS.** The research and development phase and the production phase of a phased contract shall remain as two separate contracts and shall be taxed as such. Items produced for functional use in the production phase of the contract shall be subject to tax unless the purchaser provides the contractor with a resale certificate or the transfer is otherwise exempt.
- (5) **APPLICATION TO SEMICONDUCTOR INDUSTRY.** Production tooling, including a mask to be used in production, is a custom-made item and tax applies as outlined in subdivision (b)(3) or (b)(4) as applicable.

Pattern generation tapes, wafer probe test tapes, final test tapes, schematic diagrams for the probe board, and schematic diagrams for the final test load board are informational items, if transferred for archival or other informational purposes not involving a functional use. The contractor is the consumer of the direct materials.

History: Adopted November 28, 1995, effective March 22, 1996.

Regulations are issued by the State Board of Equalization to implement, interpret or make specific provisions of the California Sales and Use Tax Law and to aid in the administration and enforcement of that law. If you are in doubt about how the Sales and Use Tax Law applies to your specific activity or transaction, you should write the nearest State Board of Equalization office. Requests for advice regarding a specific activity or transaction should be in writing and should fully describe the facts and circumstances of the activity or transaction.